1994

From Tax-Favored to Tax-Penalized: The Challenge of Estate Planning for Qualified Plan Benefits in the Face of Shifting Federal Tax Policy

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From Tax-Favored to Tax-Penalized: The Challenge of Estate Planning for Qualified Plan Benefits in the Face of Shifting Federal Tax Policy*

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Lawyers face a difficult challenge in effectively planning for their clients' estates in light of the constant shifts in federal tax policy. No area of tax law illustrates this challenge better than the law governing the estate taxation of qualified plan benefits.

Even within a single tax act, the policy decisions often are inconsistent. In a recent law review article, Charles McLure described this phenomenon in the following manner:

> Even if Congress begins its deliberations with a menu of proposals that are defensible on policy grounds, at some point, the process is likely to become driven by revenue estimates, rather than by policy considerations. When this happens, proposals are adopted because they raise revenue, not because they make sense.[1]

Since most of the tax acts throughout the 80s and 90s have been primarily concerned with raising revenue, these revenue-raising initiatives have produced an unusual amount of policy inconsistency and, indeed, contradiction in the sections which have been adopted.

Furthermore, the overriding policy objectives can frequently be contradictory from one tax act to another. For example, in one tax act the dominant policy might be to enact incentives to encourage individuals to

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*This paper was originally delivered as the 1993 Shirley A. Webster Lecture on Wealth Transfer Law at the University of Iowa Law School.

Mr. Webster's long and distinguished service as Chair of the Iowa State Bar Probate Committee, and his successful work in lobbying the 1963 Iowa Probate Code through the Iowa legislature, ensured that Iowa had an effective and up-to-date set of laws governing wealth transfers at death. Indeed, the 1963 Iowa Probate Code, adopted largely as a result of Mr. Webster's leadership, contained many of the reforms later reflected in the Uniform Probate Code. I am certain that the late Professor Allan Vestal, distinguished member of the Iowa Law School faculty and a Co-Reporter for the Uniform Probate Code, took many of the ideas from the 1963 Iowa Probate Code and included them in the Uniform Probate Code which was promulgated nationally in 1969.

A letter I recently received from former University of Iowa President Sandy Boyd, for whom the Law Building is named, described Shirley Webster as one of the great people in his life, both professionally and personally. Sandy went on to describe Shirley Webster as a "wise and kindly mentor" to Sandy when he was a young faculty member. It is a great honor to deliver this lecture bearing Mr. Webster's name.

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1. Charles E. McLure Jr., The Budget Process and Tax Simplification/Complication, 45 Tax L. Rev. 25, 28 (1989).

provide for their future retirement, while in a later tax act the dominant theme might be closing the legal loopholes that enable wealthy taxpayers to reduce their tax obligations. In the latter environment, the "incentives to encourage retirement planning" of the earlier act might be viewed as "loopholes for the rich" which must be closed.

This Article reviews the inconsistencies and contradictions in the way Congress has taxed qualified plan benefits. After explaining each change in the law, the Article describes the way estate planners have responded to that change to optimize the tax situation of their clients. This phenomena has produced a constant change in common estate planning arrangements, to the point where what was once the "wrong" thing to do subsequently has become the most desirable arrangement to adopt, and vice-versa.

The term "qualified plans" refers to retirement plans described in Internal Revenue Code section 401, including pension plans, profit-sharing plans, Keogh plans, 401(k) plans, and 403(b) annuities of public universities. The term also includes individual retirement accounts, or IRAs.[2] Qualified plan assets make up a steadily increasing share of the nation's wealth. A substantial part of an individual's accumulated wealth, especially in the case of professionals, is likely to be tied up in some form of qualified retirement plan.

The section of the Internal Revenue Code governing estate taxation of qualified plan benefits is section 2039, initially adopted in 1954.[3] Before 1954, section 2039 did not exist in any form within the 1939 Internal Revenue Code. The tax courts' many and inconsistent attempts during the 40s and 50s to determine whether a joint and survivor annuity was a transfer at death and thus includable in a decedent's gross estate is the background for this section.[4] Congress adopted section 2039 to resolve the inconsistencies between the courts, and it resolved the issue by including the annuities in a decedent's gross estate.

As originally adopted, section 2039 excluded qualified plan benefits from estate taxation when payable to a beneficiary other than the executor of the participant's estate.[5] In a House discussion of the exemption for survivorship annuities paid under qualified plans, Congressman John Byrnes, then a member of the majority in the Ways and Means Committee, explained that this exclusion would be "beneficial in encouraging employees to elect to take reduced annuities with survivorship features in order to provide for the needs of widows and other dependents."[6] The requirement that the benefits be paid to a beneficiary "other than the executor" of the participant's estate to obtain the exclusion from estate taxation was derived from Code section 2042, a section dealing with the inclusion of life

2. I.R.C. § 408 (West Supp. 1994).

3. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 2039, 68A Stat. 3, 384 (1954).

4. *See, e.g.*, Edward A. Zelinsky, Transfer Taxation Without Transfer: Reflections on Employer-Provided Death Benefits, Section 2039, Disclaimers, New Forms of Wealth, and the Evolution of the Federal Estate Tax, 58 Tul. L. Rev. 974, 978-89 (1984) (analyzing case law prior to the enactment of § 2039).

5. I.R.C. § 2039(c), 68A Stat. at 384.

6. 100 Cong. Rec. 3436 (1954).

insurance proceeds in a decedent's gross estate.[7] The provision that included in a decedent's estate life insurance proceeds payable to the executor of the insured's estate had existed since at least 1918.[8] It was a natural extension to incorporate this condition in the estate tax exemption in new section 2039. Furthermore, Congress may have determined that qualified plan benefits payable to the executor of the participant's estate created probate estate assets which should be taxed like any other asset in the probate estate.

The reaction of estate planners to the new section 2039 in 1954 was predictable and uniform. Estate planners advised their clients to make their qualified plan benefits payable to a beneficiary other than the executor of their estate, thus excluding from estate taxation the benefits attributable to contributions by the participant's employer. A common beneficiary designation was a bypass trust established in the estate plan of the participant. Under the tax law at that time, the maximum marital deduction was one-half of a decedent's adjusted gross estate. A frequently used estate plan arrangement divided the participant's estate into two halves—an A Trust, creating a marital share for the surviving spouse, and a B Trust, which was a bypass trust under which the surviving spouse would receive only a life estate with the remainder passing to the children of the participant. The B Trust, or bypass trust, would be taxed in the participant's estate, but it would not be taxed again at the death of the participant's surviving spouse. If the qualified plan benefits attributable to an employer's contributions were payable to the bypass trust, they would be exempt from taxation in the participant's estate (because the beneficiary was not the executor of the participant's estate). They also would not be taxed at the surviving spouse's death, because the surviving spouse had only a life estate in the bypass trust. Thus, the surviving spouse would have the use of the benefits and those benefits would pass free of any estate tax in both estates to the next generation at the death of the surviving spouse.

The Tax Reform Act of 1976[9] was one of the most significant tax acts in our history. Among the many changes in this tax law affecting estate planning was the unification of the estate and gift tax. The Act amended section 2039 by imposing a second condition for exempting qualified plan benefits from estate taxation. The new condition required that for the qualified plan benefits to be exempt from estate taxation, they must be payable in other than a lump sum.[10] The Act also provided that the newly recognized individual retirement accounts would be subject to the same estate tax rules as other qualified plan benefits.[11]

It is difficult to identify a policy reason for the additional requirement that the benefits be paid in other than a lump sum. The only reference to the change in the Staff Explanation of the Act was that lump sum payments

7. Charles L.B. Lowndes et al., Federal Estate and Gift Taxes 259 (3d ed. 1974).

8. H.R. Rep. No. 767, 65th Cong., 2d Sess. 22 (1918).

9. Pub. L. No. 94-455, 90 Stat. 1520 (1976).

10. Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., Summary of Tax Reform Act of 1976, at 91 (Comm. Print 1976).

11. Id.

provided the estate with sufficient cash to cover the estate tax liability attributable to the payment.[12] This may exemplify the phenomenon noted earlier: Certain amendments in many tax acts are motivated simply by the need to generate some tax revenue to offset revenue decreases produced by other provisions of the tax act.

Estate planners again responded predictably and uniformly to the new condition in section 2039. In situations in which it was desirable to exempt the qualified plan benefits from estate taxation, the estate planner arranged to have the benefits payable in other than a lump sum. The Act defined "other than a lump sum" as "payable in more than one tax year of the beneficiary."[13] After this change in the law, estate planners commonly continued to designate the participant's bypass trust as the beneficiary of the qualified plan benefits. This change in estate taxation, however, introduced a dilemma for the attorney handling the administration of a deceased participant's estate. This change forced the estate attorney to choose between the favorable income taxation produced by payment in a lump sum,[14] and the exclusion from estate taxation produced by payment in other than a lump sum. The estate attorney needed to compare the marginal estate tax rate of the estate with the marginal income tax rate of the beneficiary of the proceeds to make this decision.

An amendment to section 2039 in the Revenue Act of 1978 sharpened this dilemma of choosing between favorable income taxation and favorable estate taxation.[15] This amendment clarified that the estate tax exclusion would be available for lump sum distributions of qualified plan benefits if the beneficiary did not elect the special favorable income tax treatment.[16] In hearings before the Senate Finance Committee in 1978, the Deputy Secretary of the Treasury for Tax Policy testified that he could find "no sound basis for conditioning an estate tax exclusion upon the presence or absence of favorable income tax treatment."[17] Despite the Treasury Department's recommendation to treat all lump sum payments as part of the gross estate, Congress enacted in 1978 the provision stating that the estate tax exclusion was conditioned on not electing favorable income tax treatment.

This amendment simplified estate administration somewhat by eliminating the need to ensure that benefits would be paid in more than one tax year of the recipient in order to obtain the estate tax exclusion. Now the beneficiary of the qualified plan benefits need only elect against the favorable income tax treatment. As was true previously, the most desirable

12. Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of Tax Reform Act of 1976, at 593 (Comm. Print 1976).

13. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(c)(3), 90 Stat. 1520, 1895 (1976).

14. I.R.C. § 403 (1979).

15. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978).

16. H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 210 (1978), *reprinted in* 1978 U.S.C.C.A.N. 7198, 7215.

17. Employee Stock Ownership Plans and General Stock Ownership Trusts: Hearings on S. 3241, 3233, and H.R. 13882 Before the Senate Comm. on Finance, 95th Cong., 2d Sess. 198 (1978) (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

beneficiary designation for tax purposes was the bypass trust established under the estate plan of the participant.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[18] significantly changed estate taxation of qualified plan benefits. TEFRA placed a $100,000 cap on the estate tax exclusion in section 2039.[19] While the staff-prepared General Explanation of the Act does not give a specific reason for imposing the $100,000 cap on the estate tax exclusion, the Senate Finance Committee Report and the Explanation by the staff of the Joint Committee on Taxation indicates that Congress generally was concerned about providing appropriate limitations to prevent excess accumulations of tax sheltered funds.[20]

This is an early expression of a policy objective that became more pronounced in revisions to section 2039 in subsequent years. This Staff explanation indicates that Congress intended the tax shelter available for contributions to qualified plans to provide funds only for the retirement of the participant and spouse. Any contributed funds in excess of the amount needed for that purpose should be estate-taxed, and eventually they became estate-taxed at steeper rates than other assets in the estate.

After 1982, estate planners commonly responded to the cap by placing a $100,000 limit on the amount of qualified plan benefits payable to a participant's bypass trust. The remainder of the qualified plan benefits would be subject to estate taxation, and, typically, the estate planner would make the benefits in excess of $100,000 payable to the participant's spouse or marital trust in order to exempt them from taxation in the participant's estate. Of course, these benefits would be subjected to estate taxation at the death of the surviving spouse if not consumed during the years following the participant's death.

By 1984, Congress, enormously concerned about reducing the national budget deficit, enacted the Deficit Reduction Act of 1984.[21] The Act focused on reducing the deficit and preventing further erosion of the tax base caused by tax-sheltering activities. Thus, what had once been the policy goal—to provide an incentive to encourage taxpayers to save for their retirement and support of their surviving spouses—now fell victim to the singular goal of reducing the deficit. The effect on section 2039 was a complete repeal of the estate tax exclusion for qualified plan benefits.

The Senate Finance Committee gave three reasons for eliminating the exemption.[22] First, it said the $100,000 limitation created by TEFRA had created complex allocation problems for calculating benefits excludable from the gross estate. In fact, these allocation problems were certainly no

18. Pub. L. No. 97-248, 96 Stat. 324 (1982).

19. I.R.C. § 2039(g) (1983).

20. Staff of the Joint Comm. on Taxation, 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 285 (Comm. Print 1982).

21. Pub. L. No. 98-369, 98 Stat. 494 (1984).

22. S. Rep. No. 169, 98th Cong., 2d Sess. 312 (1984). *See also* Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 824 (Comm. Print 1984).

more complex than many others in the estate planning area. Admittedly, though, the allocation formula was fairly complex to exclude a maximum of $100,000 from estate taxation. The Senate Report's second reason was that the separate exclusion for retirement benefits was unnecessary because the same benefits were eligible for the unlimited marital deduction and the unified credit. Of course, the marital deduction was not fully the equivalent of the exclusion because it would exempt the benefits from taxation only in the participant's estate and not in the surviving spouse's estate. Furthermore, the $100,000 exclusion had previously been available in addition to the unified credit. Finally, the Senate Report said that a special estate tax exclusion based on the source of an asset was not appropriate. This statement represented a complete repudiation of the reason given for the exclusion in the first place—to encourage individuals to provide for their retirement and the support of their surviving spouse.

Following the change in 1984, the allocation formulas commonly included in estate plans since 1982 were eliminated. A common estate plan arrangement after 1984 made the qualified plan benefits payable to a surviving spouse or marital trust in order to obtain a marital deduction in the estate of the participant. The benefits would, however, be taxed at the death of the surviving spouse. It was no longer possible to eliminate estate taxation of the benefits in the estates of both the participant and surviving spouse. The only option was to defer estate taxation until the death of the surviving spouse.

Another change enacted in 1978 provided that a surviving spouse could roll over the qualified plan benefits received from a deceased spouse income tax free into an individual retirement account.[23] The surviving spouse was not required to begin withdrawing funds from that individual retirement account until he or she reached the age of 70-1/2.[24] This would defer income taxation of the qualified plan benefits from the time of distribution following the participant's death to the time the surviving spouse received the benefits from the individual retirement account. The rollover opportunity was available only to benefits paid directly to a surviving spouse and not to benefits paid to a marital trust. This change prompted estate planners to provide for qualified plan benefits to be paid directly to a surviving spouse. The benefits would be included in the deceased participant's gross estate under section 2039, but would qualify for the marital deduction under section 2056. By paying the benefits directly to a surviving spouse, the spouse could defer income tax until he or she was required to begin drawing the benefits out of the individual retirement account upon reaching the age of 70-1/2.

In 1986, Congress substantially rewrote the Internal Revenue Code, resulting in a retitled Internal Revenue Code of 1986.[25] The expressed intent of this enactment was to simplify the tax law and broaden the tax

23. Revenue Act of 1978, Pub. L. No. 95-600, §§ 157(g)(1), 157(g)(4), 92 Stat. 2763, 2807-08 (1978) (current version at I.R.C. § 402(c)(9) (West Supp. 1994)).

24. I.R.C. § 401(a)(9) (1979) (current version at I.R.C. § 401 (a)(9)(B)(iv) (West Supp. 1994)).

25. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

base by removing numerous alleged loopholes. The changes in the new tax code were said to be revenue neutral.

The House Report discussing the proposed Tax Reform Act of 1986 stated that the tax code had become a maze of intricate provisions that allowed sophisticated individuals and corporations to avoid significant tax liabilities by performing complex tax-motivated transactions.[26] Congress decided that removing loopholes in the tax code was an effective way to increase revenue. In the House Report, the Ways and Means Committee specifically noted the favorable tax treatment given to pension plans.[27] The Committee stated that its goal was to ensure that the preferential tax treatment given to pension plans was limited to encouraging savings for the individual participant's own retirement. As a result of this goal, the Committee proposed higher taxes on preretirement distributions, stricter limits on contributions and more nondiscriminatory rules to prevent plans used only by highly compensated employees.[28]

The enactment in 1986 of a supplementary excise tax of 15% on annual distributions in excess of the greater of $150,000 or $112,500 indexed annually was a major development in the taxation of qualified plans.[29] Consistent with the new excise tax on distributions, Congress imposed an additional estate tax equal to 15% of an individual's "excess retirement accumulations."[30] The Act defined an "excess retirement accumulation" as the present value of all of an individual's qualified plan benefits over a threshold figure of the present value of a lifetime annuity for the participant equal to the greater of $150,000 or $112,500 indexed from 1986. In general, the 15% additional estate tax was payable on accumulations of qualified plan benefits in excess of an amount somewhere between $750,000 and $1.5 million, depending on the age of the decedent. This additional estate tax on excess accumulations of qualified plan benefits was codified in a new code section, renumbered as section 4980A in 1988. The 15% additional estate tax was not subject to any credits, such as the unified credit, nor could the marital or charitable deductions be set off against the additional estate tax on the excess retirement accumulation.[31]

The Staff Explanation of the Act indicated that Congress intended to adopt an overall limit on the amount that could be accumulated on behalf of a participant on a tax favored basis.[32] It does not necessarily follow, however, that accumulations in excess of the threshold amount should be subjected to a heavier tax rate than all other assets in the estate. The policy objective expressed in the Staff Explanation in 1982[33] (that Congress intended the qualified plan tax shelter to be available only to provide funds

26. H.R. Rep. No. 426, 99th Cong., 1st Sess. 54 (1985).

27. Id. at 57.

28. Id.

29. I.R.C. § 4981A(c) (1987) (current version at I.R.C. § 4980A(c) (West Supp. 1994)).

30. I.R.C. § 4981A(d) (1987) (current version at I.R.C. § 4980A(d) (West Supp. 1994)).

31. Id.

32. Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 755 (Comm. Print 1987).

33. *See* text following supra note 20.

for the retirement of the participant and spouse) had now caused Congress to enact a higher rate of estate taxation on plan accumulations remaining undistributed at the death of the participant.

With the enactment of the Tax Reform Act of 1986, the metamorphosis in estate taxation of qualified plan benefits became complete. These benefits had now moved from being estate-taxed more favorably than other assets in the estate to being estate-taxed more heavily than any other assets in the estate.

In 1988, Congress made further changes in the 1986 provisions in the Technical and Miscellaneous Revenue Act of 1988.[34] This Act contained clarifying and conforming amendments to the Tax Reform Act of 1986. It allowed a surviving spouse receiving all of the retirement accumulations of a deceased participant to elect not to have the additional estate tax imposed at the death of the participant.[35] Rather, as a result of this election, the Act treated the surviving spouse as the participant and imposed the additional estate tax in her or his estate.

Once again, as a result of the amendments in 1986 and 1988, estate planners had to change common estate plan provisions. Perhaps the most significant required change was in the formula clause of an estate plan that attempted to reduce to zero the estate tax in the estate of a qualified plan participant who died leaving a surviving spouse. Typically, such a formula clause placed in a credit trust the maximum amount which could pass free of any estate taxes in the decedent's estate after taking into account the credits available to the estate. Such an estate plan allocates the balance of the estate to the marital share, passing free of estate taxes as a result of the marital deduction. Because no credits offset the 15% additional estate tax, there may be no way of reducing to zero the estate taxes in an estate having an excess accumulation of qualified plan benefits. Consequently, if the amount passing to the credit trust is defined as "the maximum amount that could pass free of estate tax in the estate after taking the credits into account," there may be no amount that could meet that definition and therefore be distributed to the credit trust. In this event, the estate might lose the benefit of the unified credit. It became necessary for estate planners to modify this typical formula clause by specifically excluding from its operation any amount subject to the 15% additional estate tax.

This brief review demonstrates that on numerous occasions over the past 20 years, changes in the estate tax law relating to qualified plan benefits have necessitated changes in estate plans and qualified plan beneficiary designations. This is a highly undesirable situation. The law governing wealth transfers at death should be stable and predictable so that individuals can plan their estates with knowledge of tax consequences upon the amounts passing to their beneficiaries. It is unreasonable to expect clients to visit their attorneys almost every other year to review and frequently revise the provisions in their estate plan relating to payment of their qualified plan benefits.

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34. Pub. L. No. 100-647, 102 Stat. 3342 (1988).

35. I.R.C. § 4980A(d)(5) (1988) (current version at I.R.C. § 4980A (West Supp. 1994)).

Indeed, if one compares the common beneficiary payment arrangement before 1976 to that after 1986, it becomes clear that what was the most desirable arrangement for tax purposes before 1976 had become highly undesirable by 1986. If a plan participant had not visited an attorney to update his or her estate plan in the ten years following 1976, the participant would very likely have a qualified plan beneficiary designation naming the bypass trust as the beneficiary of his or her qualified plan benefits. The benefits would be taxable in the beneficiary's estate; they would not qualify for the marital deduction which could defer estate taxation until the death of the surviving spouse; and the benefits would not qualify for a rollover to a surviving spouse's individual retirement account which could defer income taxation of the benefits until the spouse reached age 70-1/2. Instead, the benefits would be immediately income-taxed and estate-taxed and, possibly, excise-taxed upon payment to the bypass trust. This very adverse tax consequence for many taxpayers resulted from the constant change in the Code provisions relating to taxation of qualified plan benefits.

Indeed, many estate planners do not yet fully appreciate the full impact of the shift in estate taxation of qualified plan benefits from being tax-favored to being tax-penalized. For several decades, the conventional thinking about qualified plans has been to encourage participants to place as large an amount as possible in a qualified plan and to defer distributions from the plan as long as possible. Estate planners have assumed that such deferral would always be beneficial from a tax perspective. They assumed a working participant would be in a higher current income tax bracket than he or she would be after retirement. Therefore, if the participant received the benefits during retirement, they would be taxed at a lower rate than if currently taxed as income to the participant. Furthermore, if the participant or beneficiary could delay distribution as long as possible, the benefits would grow tax-sheltered and produce a larger benefit for the children of the participant.

For those participants who are fortunate enough to accumulate large amounts of qualified plan benefits, these assumptions may no longer be true. Since the enactment of the 15% excise tax and additional estate tax on excess distributions and excess accumulations of qualified plan benefits, the old rules of thumb about placing as much as possible in a qualified plan and delaying distribution as long as possible may no longer be true for these individuals.

A hypothetical client situation demonstrates this point. The following table, marked Plan A,[36] indicates the tax result for a plan participant who assumes that it is desirable to defer income taxation by contributing as much as possible to a qualified plan and deferring distribution from the plan as long as possible.

36. The tables and tax calculations included in this paper have been prepared by Mr. Miles McNally, CLU, of Minneapolis, Minnesota. Mr. McNally is one of the leading charitable gift planners in the insurance industry, and he has served as President of the American Society of Chartered Life Underwriters.

TABLE 1

CURRENT PLAN — **Qualified Plan Distributions After TRA '86** — **Plan A**

(Impact of Excise, Income, & Estate Taxes)

Name of Corporation:	Johnson Trucking	Participant's Age:		60	Exempt Amount (1993):	144,551
Qualified Plan Participant:	Elmer Johnson, Sr.	Age of Spouse:		58	Investment Rate:	8.0%
Account Balance 12/31/93:	1,500,000	Assumed Retirement Age:		70	Income Tax Rate:	36.0%
Grandfathered Acct Balance:	0	Current Withdrawal		0	Estate Tax Rate:	55.0%
Deposit to Retirement Age:	30,000	Consumed @ Rct A/T	(Indexed)	100,000	Soc Sec Inflation Rate:	3.0%
Contribution to Charity:	0	Number of Gifts to Charity:		0	Joint Life Expectancy @70	21.5

(1) Att'd Age	Att'd Age Benef	(2) Annual Deposit to Plan	(3) Withdrawal or required Min Distrib	(4) Excise Tax Exempt Income	(5) Net Income After Inc. & Excise Tax	(6) Spend @Ret $100,000 Reinv 6.5%	(7) Account Balance @ 8.0%	(8) Excise Tax Exempt Amount	(9) Estate Taxes @ 55%	(10) Income Taxes @ 36%	(11) Excise Taxes @ 15%	(12) Net Bal Acct+Reinv to Heirs	(13) Total % Net after Tax To Heirs
60	58	30,000	0	0	0	0	1,650,000	1,342,894	882,164	276,421	46,066	445,349	26.99%
61	59	30,000	0	0	0	0	1,812,000	1,319,381	955,959	308,175	73,893	473,973	26.16%
62	60	30,000	0	0	0	0	1,986,960	1,324,366	1,038,164	341,567	99,389	507,840	25.56%
63	61	30,900	0	0	0	0	2,176,817	1,338,331	1,128,074	377,547	125,773	545,422	25.06%
64	62	31,827	0	0	0	0	2,382,789	1,351,413	1,225,445	416,644	154,706	585,994	24.59%
65	63	32,782	0	0	0	0	2,606,194	1,363,384	1,330,875	459,115	186,422	629,783	24.16%
66	64	33,765	0	0	0	0	2,848,455	1,374,080	1,445,014	505,239	221,156	677,046	23.77%
67	65	34,778	0	0	0	0	3,111,109	1,383,369	1,568,572	555,314	259,161	728,063	23.40%
68	66	35,822	0	0	0	0	3,395,820	1,391,177	1,702,318	609,661	300,696	783,145	23.06%
69	67	36,896	0	0	0	0	3,704,382	1,397,525	1,847,094	668,623	348,028	842,635	22.75%
70	68		172,297	194,264	110,270	10,270	3,828,435	1,402,395	1,911,140	692,260	363,906	871,400	22.70%
71	69		186,753	200,092	119,522	27,459	3,947,957	1,405,899	1,976,759	715,068	381,309	902,280	22.70%
72	70		202,459	206,095	129,574	52,728	4,061,334	1,407,913	2,043,827	736,743	398,013	935,479	22.74%
73	71		219,532	212,278	139,412	86,295	4,166,710	1,408,305	2,111,584	756,932	413,761	970,728	22.82%
74	72		238,098	218,646	149,465	128,818	4,261,949	1,406,825	2,179,374	775,233	428,269	1,007,891	22.95%
75	73		258,300	225,206	160,348	181,612	4,344,605	1,403,144	2,246,749	791,187	441,219	1,047,062	23.13%
76	74		280,297	231,962	172,140	246,151	4,411,876	1,397,107	2,313,196	804,263	452,215	1,088,353	23.37%
77	75		304,267	238,921	184,929	324,093	4,460,559	1,388,608	2,378,122	813,847	460,793	1,131,889	23.66%
78	76		330,412	246,088	198,815	417,297	4,486,992	1,377,726	2,440,844	819,238	466,390	1,177,817	24.02%
79	77		358,959	253,471	213,911	527,854	4,486,992	1,364,783	2,500,583	819,622	468,331	1,226,309	24.45%
80	78		390,173	261,075	230,346	658,119	4,455,778	1,350,020	2,556,418	814,077	465,884	1,277,538	24.98%
81	79		424,360	268,907	248,272	810,746	4,387,880	1,333,915	2,607,292	801,539	458,095	1,331,700	25.62%
82	80		461,882	276,975	267,868	988,737	4,277,029	1,316,738	2,651,947	780,799	444,044	1,388,976	26.38%
83	81		503,180	285,284	289,351	1,195,502	4,116,011	1,298,791	2,688,912	750,465	422,583	1,449,553	27.29%
84	82		548,601	293,842	312,989	1,434,940	3,896,490	1,279,941	2,716,421	708,943	392,482	1,513,584	28.39%
85	83		599,460	302,658	339,134	1,711,549	3,608,750	1,255,784	2,732,044	654,501	352,945	1,580,808	29.71%
86	84		656,136	311,737	368,267	2,030,596	3,241,313	1,228,813	2,733,519	584,864	301,875	1,651,651	31.33%
87	85		720,292	321,090	401,106	2,398,406	2,780,328	1,198,962	2,717,841	497,379	237,205	1,726,308	33.33%
88	86		794,379	330,722	438,854	2,822,914	2,208,374	1,166,162	2,681,225	388,710	156,332	1,805,020	35.88%
89	87		883,349	340,644	483,938	3,314,990	1,501,694	1,130,340	2,618,540	254,304	55,703	1,888,138	39.20%
90	88		1,001,129	350,863	543,183	3,893,036	620,700	1,091,411	2,482,555	100,553	0	1,930,628	42.77%
91	89		670,356	361,389	382,683	4,342,737	0	0	2,388,505	0	0	1,954,232	45.00%

Present Value @ 7% of Net Income: 1,324,637 To Beneficiary Life Expectancy... Age 89.5 Assumed Discount Factor @ Death 8.00% 01/20/95

As indicated at the top of Plan A, the participant is an individual named Elmer Johnson, President of Johnson Trucking, who is currently age 60. He has a balance in his qualified plan account as of December 31, 1992, of $1,500,000. He can contribute a maximum $30,000 per year to the qualified plan. This maximum amount begins to be indexed in 1996. Elmer Johnson has named his wife, who is two years younger than he is, as the beneficiary of the qualified plan benefits. The illustration assumes that Elmer Johnson will retire at age 70 and that thereafter, he and Mrs. Johnson will consume $100,000 per year after taxes. This $100,000 consumption amount will be indexed after retirement.

The amount exempt from the 15% excise tax is the greater of $150,000 or $112,500 indexed from 1986. As indicated in the upper right-hand corner of the table, the 1993 indexed value of $112,500 is $144,551. This indexed amount will become greater than $150,000 in 1995, assuming an annual inflationary increase of 3%. The projections in the table assume a growth in the qualified plan account of 8% per year. The assumed income tax rate of the qualified plan beneficiary is 36%. The estate tax rate for the estate of the survivor of Mr. and Mrs. Elmer Johnson is assumed to be 55%. This means that the size of the decedent's taxable estate would exceed $3,000,000, but be less than $10,000,000, at which point a 5% surtax increases the estate tax rate to 60%. Neither the assumed income tax rate nor the estate tax rate includes state taxes in addition to the federal tax rates. The assumed social security inflation rate is 3%.

The horizontal lines on the table report the combined income and estate tax burden based on the year of the surviving spouse's death. The vertical column at the far right, column 13, reflects the percent of the qualified plan assets that would pass to the next generation of beneficiaries after the death of the surviving spouse. For most years, the percent of the qualified plan benefits passing to the heirs after payment of estate, income and excise taxes would be less than 25%. This means that 75% or more of the qualified plan benefits would be paid to the federal government in taxes. This astonishingly high level of taxation has caused some commentators to describe the current tax law regarding qualified plan benefits as creating an "IRA for the IRS." The more people contribute to their pensions and other qualified plans, and the more success they have in investing the plan assets, the greater the amount that will pass to the IRS at their death. This extremely high level of taxation raises serious doubts about the wisdom of placing as many dollars as possible into a qualified plan and deferring distribution from the plan as long as possible.

A more detailed review of the numbers in Plan A illustrates the problems with such planning. Column 1 reports the age of the participant and spouse in each year. Column 2 describes the maximum amount that can be contributed to the plan through age 70, the assumed age of retirement. Column 3 indicates the required minimum distribution from the plan. The law requires no amount to be distributed until Elmer Johnson reaches age 70-1/2. Note in the assumptions at the top of the page that the joint life expectancy of Elmer Johnson and his wife when he reaches age 70 is 21.5 years. Consequently, Mr. Johnson must receive 1/21st of the plan account in that first year of distribution. The next year, when Elmer

Johnson is age 71, he must receive 1/20th of the accumulated amount. The following year, he must receive 1/19th, and so on.

Table 2 shows the calculation of the increasing required minimum distribution. The column labeled "Withdrawal" illustrates the rapid increase in the amount of the required distribution. The column labeled "Net A/T" (after taxes) shows the amount of distribution remaining after payment of income and excise taxes. The hypothetical assumes that the Johnsons will consume $100,000 after taxes in 1970, the year of retirement, and that the amount of consumption will grow by 3% each year thereafter —as shown in the last column on the table.

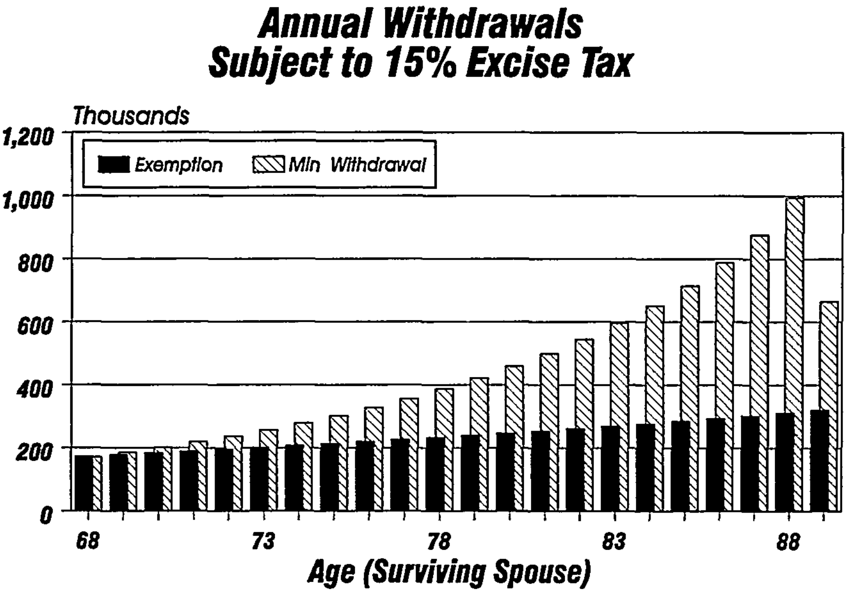
Table 2

ANNUAL WITHDRAWALS

Age	Withdrawal	Rate	Net A/T	Spent
70	172,297	1/21.5	110,270	100,000
71	186,753	1/20.5	119,522	103,000
72	202,459	1/19.5	129,574	106,090
73	219,532	1/18.5	139,412	109,273
74	238,098	1/17.5	149,465	112,551
•				
•				
•				
89	883,349	1/2.5	483,938	175,351

Column 4 of Table 1, Plan A, reflects the indexed threshold amount for imposition of the 15% excise tax. By the time Elmer Johnson is age 70, $112,500 indexed has grown to over $194,000. The required minimum distribution will exceed the indexed exempt level when Elmer Johnson reaches age 73. The required minimum distribution will grow rapidly thereafter, while the indexed threshold amount exempt from the excise tax will grow by only 3% per year. This will cause the amount subject to the 15% excise tax on distributions to grow very rapidly year by year as shown in Table 3.

Table 3



Column 5 of Table 1 indicates for each year the amount of the distribution remaining after payment of income and excise taxes. As previously discussed, the table assumes that Mr. and Mrs. Johnson will consume $100,000 of this amount (indexed after age 70) each year after retirement and invest the remainder of the distribution in a tax-exempt investment, such as municipal bonds. Column 6 shows the accumulated amount of such investments growing at a rate of 6.5% per year. For example, when Elmer Johnson is age 70 and the net distribution after payment of income and excise taxes is $110,270, a balance of $10,270 will be available to invest in tax-exempt municipal bonds after the Johnsons consume $100,000. Column 7 reflects the amount in the qualified plan each year, assuming an annual growth rate of 8% and a deduction of the distribution each year.

The vertical line after column 7 indicates that the columns to the right of the line reflect tax consequences following the death of the surviving spouse. Column 8 indicates the amount that would be exempt from the 15% additional estate tax in each year. This amount is the present value of a life annuity equal to the distribution amount exempt from excise tax for a participant of the indicated age. Column 11 indicates the amount of additional estate tax to be paid on that portion of the qualified plan benefits in excess of the exempt amount (the difference between column 7 and column 8). The additional estate tax is then subtracted from the amount of benefits. That balance is taxed at the rate of 55%, producing the tax shown in column 9 labeled "Estate Taxes."

Column 10 reflects the federal income taxes the recipient of the qualified plan benefits will pay after taking into account the deduction for income in respect of a decedent. Column 12 reports the amount that will pass to the heirs of the Johnsons' following their deaths. This amount is the sum of the amounts in columns 6 and 7, after subtracting the taxes shown in columns 9, 10, and 11. Column 13 reports the amounts passing to the heirs in column 12, as a percentage of the amounts in columns 6 and 7.

Table 1 demonstrates the extraordinarily high level of taxation on qualified plan benefits under the current tax law. The cost of deferring income taxation by contributing to a qualified plan is a combined rate of taxation that often exceeds 75% of the assets in the plan. Taxpayers with large accumulations of qualified plan benefits should consider the option of taking assets out of the plan, causing them to be estate-taxed at a rate no greater than that paid on all other assets in the estate. Removing assets from the plan will result in the imposition of an income tax, but that income tax will ultimately have to be paid whenever the benefits are distributed from the plan. Estate planners should plan the distributions carefully to avoid the 15% excise tax on excess distributions.

The tax results of Plan A are shown in Graph 1. The amount passing to the heirs is the portion in the lowest area; the amount paid in estate tax is the portion in the next area; the amount paid in income taxes is the portion in the white area; and the amount paid in excise taxes and additional estate taxes is the portion in the top area. Significantly, the lowest area is quite small compared to the three higher areas. In Plan A, the bulk of Elmer Johnson's benefits are paid to the government in the top three tax categories, leaving a relatively small portion in the lowest area for his heirs.

Graph 1

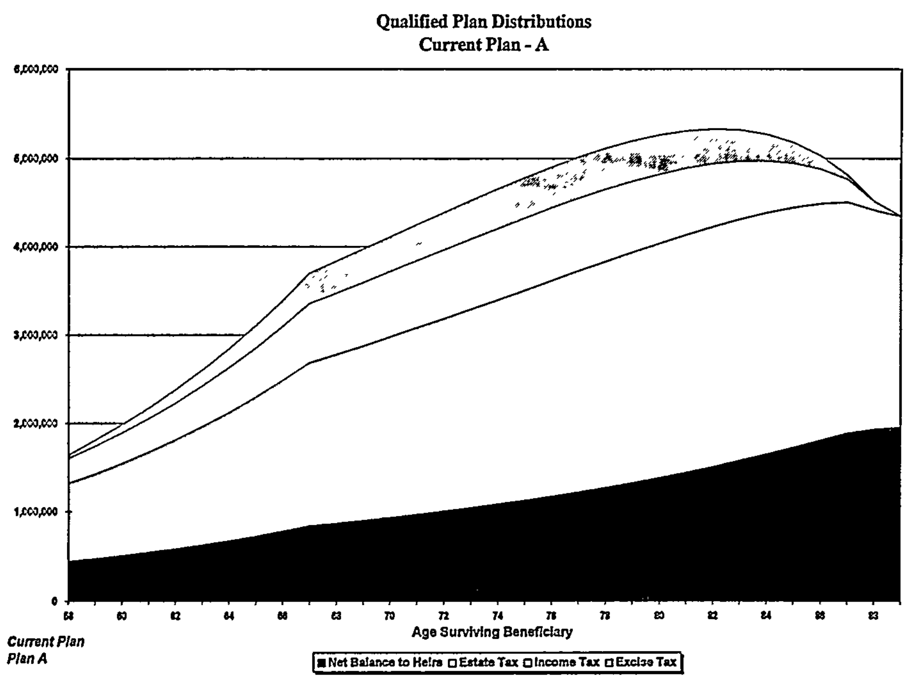


TABLE 4

PROPOSED PLAN **Qualified Plan Distributions After TRA '86** **Plan B**

Wealth Replacement - Remainder to Charity (Impact of Excise, Income, & Estate Taxes)

Name of Corporation:	Johnson Trucking	Participant's Age:	60	Exempt Amount (1993):	144,551
Qualified Plan Participant:	Elmer Johnson, Sr.	Assumed Retirement Age:	70	Investment Rate:	8.0%
Account Balance 12/31/93:	1,500,000	Current Withdrawal:	120,000	Income Tax Rate:	36.0%
Grandfathered Acct Balance:	0	Consumed @ Ret A/T (Indexed)	100,000	Estate Tax Rate:	55.0%
Deposit to Retirement Age:	30,000	Survivorship Insurance:	1,000,000	Soc Sec Inflation Rate:	3.0%
Contribution to Charity:	15,000	Number of Gifts to Charity:	10	Joint Life Expectancy @70	21.5

(1) Att'd Age	Att'd Age Benef	(2) Deposit Less Gift to Charity	(3) With'd or req'd Min Dist	(4) Ins Prem and/or CRT Income	(5) Net Inc. After Inc & Excise Tax	(6) Spend @Ret $100,000 Reinv 6.5%	(7) Account Balance @8.0%	(8) Excise Tax Exempt Amount	(9) Survivor Insurance Death Ben	(10) Estate Taxes @ 55%	(11) Income Taxes @ 36%	(12) Excise Taxes @ 15%	(13) Net Bal of Acct to Heirs
60	58	15,000	120,000	13,407	63,393	63,393	1,515,000	1,342,894	1,000,000	853,917	250,542	25,816	1,448,118
61	59	15,000	120,000	13,407	63,393	130,907	1,531,200	1,319,381	1,000,000	896,684	254,345	31,773	1,479,305
62	60	15,000	120,000	13,407	63,393	202,808	1,548,698	1,324,366	1,000,000	944,820	257,551	33,649	1,515,483
63	61	15,900	120,000	13,407	63,393	279,384	1,568,492	1,338,331	1,000,000	897,343	260,931	34,524	1,555,077
64	62	16,827	120,000	13,407	63,393	360,937	1,590,798	1,351,413	1,000,000	1,053,705	264,819	35,908	1,597,303
65	63	17,782	120,000	13,407	63,393	447,791	1,615,844	1,363,384	1,000,000	1,114,171	269,265	37,869	1,642,330
66	64	18,765	120,000	13,407	63,393	540,290	1,643,876	1,374,080	1,000,000	1,179,034	274,321	40,469	1,690,343
67	65	19,778	120,000	13,407	63,393	638,802	1,675,165	1,383,369	1,000,000	1,248,609	280,043	43,769	1,741,546
68	66	20,822	120,000	13,407	63,393	743,717	1,710,000	1,391,177	1,000,000	1,323,241	286,489	47,823	1,796,163
69	67	21,896	120,000	13,407	63,393	855,452	1,748,696	1,397,525	1,000,000	1,403,310	293,718	52,676	1,854,444
70	68		120,000	0	76,800	887,856	1,768,591	1,402,395	1,000,000	1,430,835	297,388	54,929	1,873,295
71	69		120,000	0	76,800	919,367	1,790,079	1,405,899	1,000,000	1,458,500	301,403	57,627	1,891,916
72	70		120,000	0	76,800	949,836	1,813,285	1,407,913	1,000,000	1,486,273	305,792	60,806	1,910,250
73	71		120,000	0	76,800	979,102	1,838,348	1,408,305	1,000,000	1,514,119	310,585	64,506	1,928,240
74	72		120,000	0	76,800	1,006,993	1,865,416	1,406,825	1,000,000	1,541,991	315,817	68,789	1,945,812
75	73		120,000	0	76,800	1,033,320	1,894,649	1,403,144	1,000,000	1,569,834	321,531	73,726	1,962,879
76	74		122,235	0	78,231	1,059,312	1,923,985	1,397,107	1,000,000	1,597,346	327,334	79,032	1,979,585
77	75		132,689	0	84,921	1,090,100	1,945,215	1,388,608	1,000,000	1,623,503	331,656	83,491	1,996,665
78	76		144,090	0	92,218	1,126,497	1,956,743	1,377,726	1,000,000	1,648,013	334,189	86,853	2,014,185
79	77		156,539	0	100,185	1,169,428	1,956,743	1,364,783	1,000,000	1,670,557	334,574	88,794	2,032,246
80	78		170,152	0	108,897	1,219,946	1,943,131	1,350,020	1,000,000	1,690,760	332,403	88,967	2,050,947
81	79		185,060	0	118,438	1,279,257	1,913,521	1,333,915	1,000,000	1,708,211	327,205	86,941	2,070,422
82	80		201,423	0	128,911	1,348,744	1,865,179	1,316,738	1,000,000	1,722,411	318,448	82,266	2,090,798
83	81		219,433	0	140,437	1,429,996	1,794,961	1,298,791	1,000,000	1,732,792	305,520	74,426	2,112,219
84	82		239,328	0	153,170	1,524,857	1,699,230	1,279,941	1,000,000	1,738,656	287,728	62,893	2,134,809
85	83		261,420	0	167,309	1,635,484	1,573,748	1,255,784	1,000,000	1,738,846	264,391	47,695	2,158,301
86	84		286,138	0	183,127	1,764,447	1,413,512	1,228,813	1,000,000	1,732,640	234,474	27,705	2,183,140
87	85		314,114	0	201,033	1,914,884	1,212,479	1,198,962	1,000,000	1,718,935	196,823	2,028	2,209,578
88	86		346,423	0	219,355	2,088,464	963,055	1,166,162	1,000,000	1,678,335	156,015	0	2,217,168
89	87		385,222	0	239,855	2,288,719	654,877	1,130,340	1,000,000	1,618,978	106,090	0	2,218,528
90	88		436,585	0	266,556	2,523,430	270,683	1,091,411	1,000,000	1,536,762	43,851	0	2,213,500
91	89		292,337	0	187,096	2,688,520	0	0	1,000,000	1,478,686	0	0	2,209,834

PV @ 7% of Net Income: 1,148,970 To Beneficiary Life Expectancy... Age 89.5 Assumed Discount Factor @ Death 8.00%

How can this extremely high level of taxation be reduced? Table 4, Plan B, shows one approach to reducing the level of taxation. In Plan B, Elmer Johnson continues to shelter $30,000 of his income each year from income taxation, but he divides that amount between gifts to charity and contributions to his qualified plan. Under this plan, Elmer Johnson will contribute $15,000 a year to charity for the next ten years, for a total charitable gift of $150,000. He will contribute the balance of the sheltered $30,000 to his qualified plan as indicated in column 2. Column 3 shows that instead of waiting until age 70 to take withdrawals from the plan, Elmer Johnson will begin to withdraw $120,000 per year from the plan immediately. In addition, Elmer Johnson will purchase a $1 million insurance policy payable on the death of the survivor of the Johnsons. This policy is purchased under a vanishing premium plan, which assumes that $13,407 will be the insurance premium for each of the next ten years after which the premium will be paid by dividends from the policy.

Column 5 on Table 4, Plan B, shows the amount of distribution remaining after payment of the income taxes and the insurance premium. Once again, column 6 assumes that the amount in column 5 has been invested in tax-exempt municipal bonds growing at a rate of 6.5% per year. After age 70, the Johnsons will consume $100,000 a year, indexed, out of the amount in column 6. The qualified plan account balance in column 7 grows more slowly in Plan B than in Plan A, because Plan B provides for immediate annual distributions.

Plan B assumes that the Johnsons transfer ownership of the insurance policy to an irrevocable trust, which would shelter the policy from estate taxation at the death of the surviving spouse. Some in the insurance industry refer to this type of trust as a "wealth replacement trust." The arrow on the chart next to the annual distribution when Elmer Johnson is age 88 and Mrs. Johnson is 86 indicates that, for the first time, the distribution from the plan will become subject to the excise tax of 15%. Under Plan A, by contrast, the excise tax becomes payable when Elmer Johnson is age 73.

The amount of benefits passing to the heirs in column 13 of Plan B greatly exceeds the amounts passing to the heirs in column 12 of Plan A. The amount in Plan B is more than $1 million greater than in Plan A in each of the next 11 years. The increase is somewhat less thereafter, but still remains more than $600,000 greater when Elmer Johnson is age 84. In percentage terms, Plan B increases the percent of qualified plan benefits passing to the heirs to over 50% of the amounts of gross benefits as reported in columns 6, 7, and 9. The Johnsons achieve this great increase in the amount passing to their children even after their gift to charity of $15,000 per year in each of the next 10 years.

This result is shown in Graph 2. The lowest area passing to the heirs has grown and the amount paid in taxes has shrunk. Indeed, the amount paid in excise taxes and additional estate taxes—the top area—has almost disappeared.

Graph 2

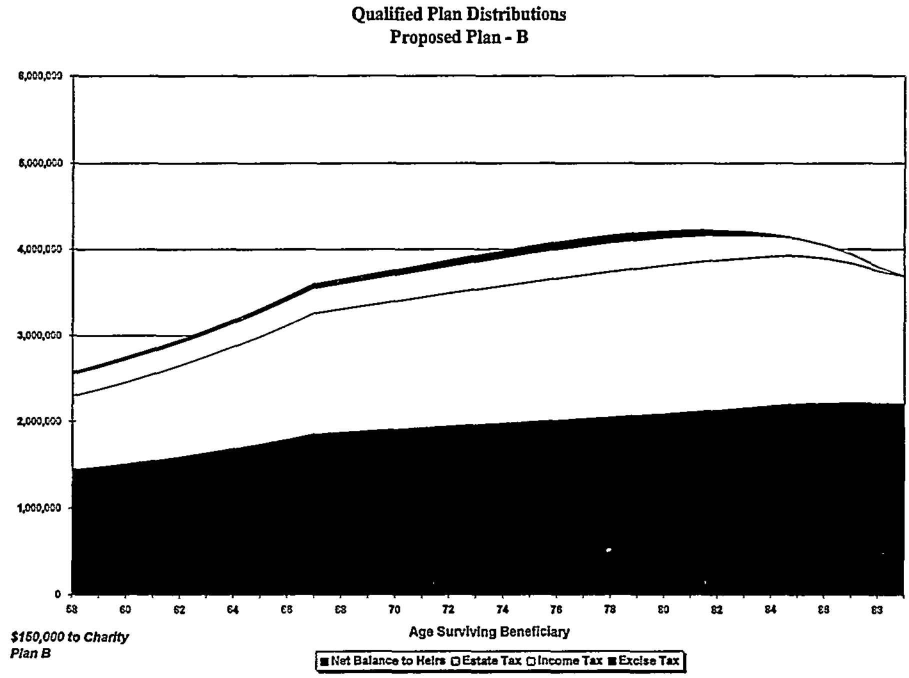


Table 4, Plan B, demonstrates the advisability, at least in Mr. Johnson's situation, of not making the maximum contribution to a qualified plan and not delaying distribution as long as possible. It also demonstrates the tax desirability of taking amounts out of the plan account to pay premiums on a policy of life insurance on the life of the participant and spouse. This is a source of funds for premiums which does not diminish the spending power of the participant. While the distribution of the amount used to pay the premiums admittedly will produce an income tax, the taxpayer eventually must pay that income tax whenever the benefits are distributed. In this plan, the current distributions are not subject to the 15% excise tax. The table also demonstrates the desirability of purchasing life insurance on the participant's life outside of the qualified plan rather than within the plan. Since an irrevocable life insurance trust or, to use the insurance industry's jargon, a "wealth replacement trust," remains one of the few ways of transferring property free of estate taxes in the estates of both spouses, planners can look to the funds in a qualified plan as a source of premiums to pay for such insurance and obtain the benefits of this irrevocable trust.

Some individuals may not wish to make gifts to charity during their lifetime, but would prefer to make such gifts at death. Such a plan is reflected in Table 5, Plan C. In Plan C, Mr. Johnson will continue to deposit the maximum of $30,000 per year, indexed beginning in 1996, into his qualified plan. As in Plan B, however, he will immediately begin to take distributions of $120,000 per year. Plan C also assumes the purchase of a $1 million survivorship life insurance policy owned by an irrevocable, or

TABLE 5

ALTERNATE PLAN **Qualified Plan Distributions After TRA '86** **Plan C**
Wealth Replacement - Remainder to Charity (Impact of Excise, Income, & Estate Taxes)

Name of Corporation:	Johnson Trucking	Participant's Age:	60	Exempt Amount (1993):	144,551
Qualified Plan Participant:	Elmer Johnson, Sr.	Assumed Retirement Age:	70	Investment Rate:	8.0%
Account Balance 12/31/93:	1,500,000	Current Withdrawal:	120,000	Income Tax Rate:	36.0%
Grandfathered Acct Balance:	0	Consumed @ Ret A/T (Indexed)	100,000	Estate Tax Rate:	55.0%
Deposit to Retirement Age:	30,000	Survivorship Insurance:	1,000,000	Soc Sec Inflation Rate:	3.0%
Remainder to Charity:	150,000	Assumed first death at:	80	Joint Life Expectancy @70	21.5

(1) Att'd Age	Att'd Age Benef	(2) Deposit Less Gift to Charity	(3) With'd or req'd Min Dist	(4) Ins Prem and/or CRT Income	(5) Net Inc. After Inc & Excise Tax	(6) Spend @Ret $100,000 Reinv 6.5%	(7) Account Balance @8.0%	(8) Excise Tax Exempt Amount	(9) Survivor Insurance Death Ben	(10) Estate Taxes @ 55%	(11) Income Taxes @ 36%	(12) Excise Taxes @ 15%	(13) Net Bal of Acct to Heirs
60	58	15,000	120,000	13,407	63,393	63,393	1,515,000	1,342,894	1,000,000	853,917	250,542	25,816	1,448,118
61	59	15,000	120,000	13,407	63,393	130,907	1,531,200	1,319,381	1,000,000	896,684	254,345	31,773	1,479,305
62	60	15,000	120,000	13,407	63,393	202,808	1,548,696	1,324,366	1,000,000	944,820	257,551	33,649	1,515,483
63	61	15,900	120,000	13,407	63,393	279,384	1,568,492	1,338,331	1,000,000	997,343	260,931	34,524	1,555,077
64	62	16,827	120,000	13,407	63,393	360,937	1,590,798	1,351,413	1,000,000	1,053,705	264,819	35,908	1,597,303
65	63	17,782	120,000	13,407	63,393	447,791	1,615,844	1,363,384	1,000,000	1,114,171	269,265	37,869	1,642,330
66	64	18,765	120,000	13,407	63,393	540,290	1,643,876	1,374,080	1,000,000	1,179,034	274,321	40,469	1,690,343
67	65	19,778	120,000	13,407	63,393	638,802	1,675,165	1,383,369	1,000,000	1,248,609	280,043	43,769	1,741,546
68	66	20,822	120,000	13,407	63,393	743,717	1,710,000	1,391,177	1,000,000	1,323,241	286,489	47,823	1,796,163
69	67	21,896	120,000	13,407	63,393	855,452	1,748,696	1,397,625	1,000,000	1,403,310	293,718	52,676	1,854,444
70	68		120,000		76,800	887,856	1,768,591	1,402,395	1,000,000	1,430,835	297,388	54,929	1,873,295
71	69		120,000		76,800	919,367	1,790,079	1,405,899	1,000,000	1,458,500	301,403	57,627	1,891,916
72	70		120,000		76,800	949,836	1,813,285	1,407,913	1,000,000	1,486,273	305,792	60,806	1,910,250
73	71		120,000		76,800	979,102	1,838,348	1,408,305	1,000,000	1,514,119	310,585	64,506	1,928,240
74	72		120,000		76,800	1,006,993	1,865,416	1,406,825	1,000,000	1,541,991	315,817	68,789	1,945,812
75	73		120,000		76,800	1,033,320	1,894,649	1,403,144	1,000,000	1,569,834	321,531	73,726	1,962,879
76	74		122,235		78,231	1,059,312	1,923,985	1,397,107	1,000,000	1,597,346	327,334	79,032	1,979,585
77	75		132,689		84,921	1,090,100	1,945,215	1,388,608	1,000,000	1,623,503	331,656	83,491	1,996,665
78	76		144,090		92,218	1,126,497	1,956,743	1,377,726	1,000,000	1,648,013	334,189	86,853	2,014,185
79	77		156,539		100,185	1,169,428	1,956,743	1,364,783	1,000,000	1,670,557	334,574	88,794	2,032,246
80	78		170,152	→	12,897	1,123,946	1,943,131	1,350,020	1,000,000	1,637,960	332,403	88,967	2,007,747
81	79		185,060	(6,720)	125,158	1,183,737	1,913,521	1,333,915	1,000,000	1,655,675	327,205	86,941	2,027,438
82	80		201,423	(6,720)	135,631	1,253,735	1,865,179	1,316,738	1,000,000	1,670,156	318,448	82,266	2,048,044
83	81		219,433	(6,720)	147,157	1,335,531	1,794,961	1,298,791	1,000,000	1,680,837	305,520	74,426	2,069,710
84	82		239,328	(6,720)	159,890	1,430,972	1,699,230	1,279,941	1,000,000	1,687,020	287,728	62,893	2,092,561
85	83		261,420	(6,720)	174,029	1,542,217	1,573,748	1,255,784	1,000,000	1,687,549	264,391	47,695	2,116,331
86	84		286,136	(6,720)	189,847	1,671,838	1,413,512	1,228,813	1,000,000	1,681,705	234,474	27,705	2,141,466
87	85		314,114	(6,720)	207,753	1,822,975	1,212,479	1,198,962	1,000,000	1,668,385	196,823	2,028	2,168,219
88	86		346,423	(6,720)	226,075	1,997,301	963,055	1,166,162	1,000,000	1,628,195	156,015	0	2,176,145
89	87		385,222	(6,720)	246,575	2,198,350	654,877	1,130,340	1,000,000	1,569,275	106,090	0	2,177,862
90	88		436,585	(6,720)	273,276	2,433,908	270,683	1,091,411	1,000,000	1,487,525	43,851	0	2,173,215
91	89		292,337	(6,720)	193,816	2,599,898	0	0	1,000,000	1,429,944	0	0	2,169,954

PV @ 7% of Net Income: 1,146,798 To Beneficiary Life Expectancy... Age 89.5 Assumed Discount Factor @ Death 8.00%

wealth replacement, trust as in Plan B. The new factor introduced in Plan C is that Elmer Johnson will make a $150,000 gift to charity, but will do so at his death rather than during his lifetime.

An outright transfer of qualified plan assets to a charity at the participant's death is a particularly "inexpensive" way to make a charitable gift. If the plan assets were transferred to family members instead, the amount they actually receive would be less than with most other assets in the estate because of the potential triple tax on qualified plan benefits. Thus, anyone planning an outright charitable gift at death should consider making the gift out of the qualified plan assets and save other assets for the family.

Despite the attractiveness of an outright charitable gift of plan assets at a participant's death, this arrangement is not suitable for some donors. In many cases, donors need plan assets to help provide an adequate level of support for a surviving spouse. For a donor who wishes to use plan assets to support both family and charitable causes, a transfer of qualified plan assets to a testamentary charitable remainder trust is ideal. Recently, the IRS ruled on the tax consequences of such a "testamentary charitable rollover."

In the fall of 1992, the IRS issued its first Private Letter Ruling (PLR) on transferring profit-sharing-plan assets to a charitable remainder trust at a participant's death. PLR 9253038 concerned a lifetime two-life charitable remainder unitrust for the donor and his wife. The trust agreement allowed for additional contributions, and the Ruling addressed the consequences of transferring a portion of the donor's profit sharing plan assets to the existing charitable remainder trust at death. The trust was a type 2 unitrust which provided that the amount to be distributed to the income beneficiary each year was the lesser of the unitrust amount or the actual income for the year, with any deficiency to be made up in future years.

The IRS ruled that it would treat the transfer of profit-sharing-plan assets to the trust like any other testamentary transfer to a charitable remainder trust. The trust would continue to qualify as a unitrust; distributions from the trust to the donor's spouse would be taxed under the usual rules; and estate tax marital and charitable deductions would be allowed for the interests created for the donor's wife and the charitable remainder beneficiary. The most significant aspect of the Ruling, however, is the IRS conclusion that the transfer of the plan assets to the unitrust will not trigger an immediate income tax on the full value of the transferred assets.

This Ruling gives estate planners and charitable gift planners a valuable new tool: It provides a way of avoiding an immediate double bite of the estate tax and income tax without the disadvantages of an outright transfer to a surviving spouse. Most importantly, the donor/plan participant specifies how the plan assets will be used at the surviving spouse's death. This vehicle is ideal for a donor who wants to provide support for a surviving spouse in the form of an income stream, but also wishes to make a substantial charitable gift.[37]

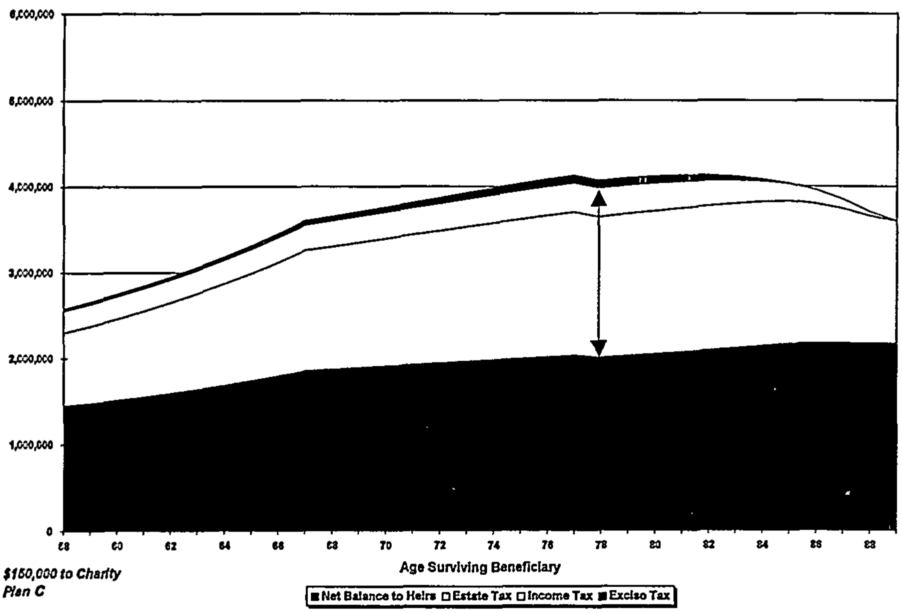
Plan C assumes that Elmer Johnson will make a $150,000 gift at his death to a charitable remainder trust in which Mrs. Johnson has a life income interest. The value of the life estate in Mrs. Johnson qualifies for the marital deduction, and the value of the remainder to charity qualifies for the charitable deduction.

Table 5, Plan C, assumes that Elmer Johnson dies at age 80, and the arrow next to column 5 shows that the $150,000 passing to the charitable remainder trust will be funded at that time. When comparing column 13 in Plan C to column 13 in Plan B, one can see in Plan C that in many years the amount passing to the heirs will be as great or greater. In both plans, the amount passing to the heirs is much greater than if no irrevocable trust is established, or if no charitable gift is made. In both Plans B and C, a charity benefits to the extent of $150,000 at little or no cost to the Johnsons' heirs.

Graph 3 illustrates the advantages of Plan C. The amount passing to the heirs of the Johnsons is, again, much greater than under Plan A.

Graph 3

Qualified Plan Distributions
Alternate Plan - C



37. The IRS recently issued a similar ruling on a transfer of assets from an individual retirement account to a charitable remainder trust at the participant's/donor's death. Priv. Ltr. Rul. 92-370-20 (June 12, 1992).

Correspondingly, the amount in the top three areas reflecting taxes paid has decreased. Again, the top area representing the 15% excise tax and additional estate tax has almost disappeared. The arrow shows the effect of the $150,000 gift to charity, revealing that the gift primarily affects taxes paid and creates a minimal impact on the heirs.

What conclusions can we draw from this review of the estate and related income taxation rules concerning qualified plan benefits? First, the constant change in section 2039 cannot be explained in terms of any consistent tax policy. Rather, these changes reflect a shifting and contradictory expression of tax policy from time to time in Congress. Indeed, some of these changes reflect no policy at all other than the need to generate additional revenue.

Second, the constant change in the tax law requires a rather constant review of estate plans and beneficiary designations to optimize tax consequences. Few participants, however, will engage in such a frequent and continuing review of their estate plan arrangements. As a result, many participants are left with beneficiary arrangements that were advantageous when designated, but which now produce undesirable tax results in light of the frequent changes in the tax law.

Third, the current tax rules which tax large accumulations of qualified plan benefits more heavily than other estate assets bring into question the two common assumptions: first, that it is desirable to shelter from income taxation as much as possible by contributing into a qualified plan, and second, that participants should delay distributions from the plan as long as possible. Under current law, acting under these assumptions can cause more than 77% of the benefits in a plan to be paid in estate, income, and excise taxes. Individuals with substantial accumulations of qualified plan benefits should review their situation with their tax advisor to determine whether their current arrangement is desirable from a tax point of view. Rather than continuing to contribute the maximum amount possible to a qualified plan and delay distributions until the mandated age, the participant may be advised to reduce current contributions to the plan and begin to take distributions out of the plan as soon as possible. While that strategy will result in an immediate income tax on the distributions from the plan, participants would eventually have to pay income tax whenever distributions occur. Further, by beginning the distributions sooner, the participant may avoid the 15% excise tax. The participant can then invest the net balance of the distributions in another tax-sheltered investment that will not be subject to the 15% additional estate tax.

Finally, there are unique opportunities to make charitable gifts out of assets which otherwise would be contributed to a qualified plan or out of the benefits payable from a qualified plan. These gifts will substantially benefit the charity of the participant's choice at very little cost to the heirs of the participant.

The shifting federal tax law regarding qualified plan benefits has presented a special challenge for estate planners. What was once the optimum arrangement became, over a very short period of time, highly undesirable from a tax perspective. Fortunately, with careful planning, the greatly increased level of combined taxation can be reduced. Opportunities are now available to make charitable gifts from the plan assets at little or no cost to the participant's family. Estate planners should meet the challenge and take advantage of these new opportunities.